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ESSENTIAL RECITALS IN THE VARIOUS KINDS OF BONDS

BY ANDREW SQUIRE, ESQ.,
Cleveland, Ohio.

A bond ordinarily is simply a promise to pay money at a given time, bearing a rate of interest, the interest usually being payable at stipulated intervals—annually or semi-annually. Such a bond is sometimes defined as

An instrument in writing, under seal, whereby one binds himself to pay a certain sum of money to another on a day named.

Bonds are issued by governments, states, counties, municipalities, school districts and other public bodies. They are frequently classified as government and state bonds, municipal bonds and corporate bonds. Municipal bonds are subdivided into city, village and hamlet bonds. There are also county bonds and school bonds; railway, street railway, gas, electric light, water, telephone, telegraph and industrial bonds, which last term includes, generally, bonds issued by private corporations engaged in some specific line of industrial development. Railroad bonds have, for many years, stood almost in a separate class.

Income bonds are bonds, frequently, whose interest, and sometimes whose principal, are made payable from the income of the party giving the bond. Government bonds, state bonds and municipal bonds are seldom secured by mortgage on property, but depend for payment upon the faith and credit of the government, state, municipal, or other public corporation, and upon taxes or revenues collected for their payment. Railroad bonds and bonds of industrial and private corporations are almost invariably secured by mortgage or pledge of property, real or personal, or both, and are commonly known as mortgage bonds, or collateral trust bonds.

The essential recitals to be made in a bond depend largely upon the statutes and laws governing the issue. It is necessary to have a knowledge of the statutes under which the bond is sought

to be issued, in order to be sure of all the recitals which should enter into any particular issue of bonds. It is quite a common practice to select some bond form which has been evolved by long continued experience and adopt and copy such a bond. Such practice is much better than to approach the subject in a haphazard manner, but no bond form should be adopted without careful investigation of the authority by which it is issued and the conclusion arrived at that the bond complies in all respects with the authority granted. These observations apply to what may be called the unusual recitals in bond forms. Some of these recitals are not essential, but at times the recitals, if they are to become part of the contract between the obligor of the bond and the one who buys it, are very essential, and it becomes very necessary to have the exact terms clearly expressed.

A bond written in any unusual phraseology is liable to attract attention and raise questions that might hinder the negotiation and sale of a bond that would not attract attention if written in the ordinary terms.

A bond secured by mortgage, whether real estate, chattel or collateral trust, should usually, in addition to containing the obligation to pay, advise the bondholder, either directly or by reference to the mortgage, of his rights and of the terms and conditions upon which the bond is issued and secured.

Ordinarily, a proper form of mortgage bond will set forth:

- (a) *An acknowledgment of the indebtedness for value received.*
- (b) *A covenant to pay the principal at a certain place and time, in lawful money, or gold coin of a fixed standard of weight and fineness, with interest at an agreed rate, payable at a specified place, and at specified times, usually semi-annually, and ordinarily represented by coupons attached to the bonds.*

For many years it has been the custom in this country to require bonds to be paid in gold coin of the present standard of weight and fineness. Since the rapid advance of prices in the last few years and the great increase in the amount of gold which is being mined annually, some long-time obligations, running from fifty to one hundred years, are giving the obligee a right to demand payment either in gold coin or in lawful money, at his option.

- (c) *A description of the issue of which the bond is one, showing usually the amount of the issue, and, oftentimes, the purposes.*
- (d) *A statement showing that the bond is secured by a mortgage or trust deed, as the case may be; the place where the instrument is recorded or filed, and a reference to the instrument for a description of the property mortgaged or pledged; the extent and character of the security, and the terms and conditions upon which the bonds are issued.*

Usually the bond is specifically made subject to the terms and conditions of the mortgage, so that, should there be any conflict between the terms of the bond and mortgage, or instrument securing the bond, the terms of the mortgage will govern.

- (e) *A recital briefly advising the bondholder of his rights on default of payment of interest or otherwise.*
- (f) *A provision that the bond shall not be valid until authenticated by a certificate endorsed thereon and executed by the trustee.*

This certificate to be executed by the trustee needs careful attention. It should not be a certificate purporting to be anything more than an identification of the bond as one of the bonds of that particular issue. The trustee should never represent that the bond is secured by a mortgage or other instrument executed to the trustee, because the trustee is not expected to in any sense determine that the bond is secured, or to what extent it may be secured. All that is asked of the trustee is to identify properly the bond and guard against an over-issue.

In addition to the foregoing, there are various special provisions which frequently occur in bonds. For instance:

1. *A provision for registration.* This in order that the bond, which is usually payable to bearer, may be registered and held so that the owner would not be deprived of his property, should the bond be stolen or destroyed by fire. If a recital of this kind is to be put into a bond, ample provision should be made for converting the bond once registered to an unregistered bond, and to make several of these changes, especially if the bond is a long-time bond and liable to pass through several ownerships.

2. *A provision for redemption prior to maturity.* Such provisions are exceedingly common in railroad and corporation issues. Experience has taught those who are in the habit of drawing bonds of this character, that almost every kind of business is liable to develop far beyond the expectations of those interested at the time a bond is put out; and that, in order to finance an increasing business, whether it be a railroad or even an ordinary corporate enterprise, upon which larger demands are being made yearly for capital to be used in the business, additional stock must be sold or additional bonds issued. Sometimes resort must be had to the one method and sometimes to the other. When it is found better to issue new bonds, it is frequently of great advantage to be able to retire the underlying bonds, and it is very wise that the bond should contain a provision permitting such retirement. As a matter of experience, the bond should usually provide for its retirement only at some interest-maturing period. Such retirement is ordinarily accompanied by an obligation to pay a premium, though not always; whatever the contract is, it should be clearly expressed upon the face of the bond. There can be said to be no uniform custom as to the amount of the premium, as bonds are seen upon the market which provide for their redemption at all the way from par to 115 or 120 per cent of their face. The ordinary provisions, however, usually observed, make a redemption possible at from 102 or 103 to 110.

3. *For a sinking fund.* The sinking fund provision in a bond is sometimes a difficult one to deal with. The experience of the writer is that a sinking fund provision is frequently insisted upon, in close times, by a bond buyer, when it should not be submitted to by the person issuing the bond, and that the bond buyer would not insist upon it if he gave careful thought to its effect. This observation, of course, is true only with reference to certain kinds of bonds, such as bonds issued by street railway, electric light, water and gas companies, in rapidly growing municipalities where the service rendered is at the time of the issue of the bonds grossly inadequate to the demands of the municipality. In every such case, all income that can be earned above a fair dividend on the money invested can be put to better advantage, of both the bond-giver and the bondholder, in extensions and improvements of the plant than in providing a sinking fund. Any attempt to

compel the bond-giver to apply such earnings towards a sinking fund hampers and checks the growth of the plant and the proper development of the enterprise and is not so beneficial a security as such an amount would be, properly expended upon extensions and betterments to the existing plant. There is a character of bond, however, where the reverse is true and where a sinking fund is absolutely essential to protect the bond buyer. A familiar instance of this is a coal bond, or a bond upon a coal mine. Take, for instance, a bond issue of \$5,000,000 upon an estimated coal tonnage of 200,000,000 tons. It is essential that, as the coal is mined, some provision should be made for the payment of the bonds, which provision should be certain and definite. In the illustration used, a sinking fund of five cents per ton (which should be absolutely used for the retirement of the bonds, the interest to be paid besides) would retire the bonds or provide for their retirement at least as soon as one-half the coal is mined.

The illustration used is, perhaps, hardly a fair one, for it is frequently the case that bond issues are put on very much nearer to the value of the property. Other instances will readily suggest themselves. Vessel bonds, where the vessel is liable to decay and largely to depreciate, should have a sinking fund, and every bond, where the security is necessarily rapidly deteriorating. Such recitals should be specific and the trustee should rigidly enforce them. The trustee's attention is especially directed to see that strict observance is had of all sinking fund provisions. Instances are known where a trustee, by neglect, has permitted sinking fund provisions to be violated and the corpus of the property to be wasted before the maturity of the bond.

The main idea in the matter of sinking fund provisions, is that such provision should be intelligently written with reference to the particular issue of bonds, and that the bond buyer and bond seller should both have a thorough knowledge of the property.

4. *For the exemption of stockholders, directors and officers of the corporation from individual liability for the payment of principal and interest of bonds.*

Provisions like this arise mainly from two causes: First, in the original promotion of many enterprises property which is of an uncertain value is, under a contract, turned over to a corporation,

sometimes accompanied with a money payment and sometimes without; sometimes in an undeveloped condition and sometimes in a developed condition, for a given number of bonds and a given amount of stock, all of which are issued as fully paid, and then the bonds and stock are put upon the market by the party making the proposition. If the enterprise turns out successful no question arises, but if, as is not infrequent, the enterprise is a failure, and the property mortgaged will not sell for sufficient to pay the outstanding bonds, then the bondholder (who is frequently an innocent person) looks to see if he cannot hold the original promoters, the stockholders, directors and officers in some way, for any deficiency. To guard against being so held, recitals of the character suggested are frequently put in the bonds.

A second reason for such a recital arises from the double statutory liability provided for in some of the states. The constitution of some states provides that all stockholders shall be liable for an additional amount up to the amount of the holding of their stock to pay the indebtedness of the corporation. Most states have no such provision, but wherever such provisions do exist they make trouble and give rise to a considerable amount of litigation. Such litigation it is sought to escape by a contract provision in the bond or mortgage.

A recital of the character suggested should be full and distinct in the bond to be effective, and so written that the holder of the bond, by the mere fact of buying it, becomes a party to the contract expressed in the paragraph, and he agrees to release, to the extent provided, the officers, directors and stockholders from individual liability. As to the construction of such provisions and their validity, the courts have not all agreed. They are, however, generally enforced if specific. In order to be so enforced the courts have leaned to the holding that the provisions must be set out in sufficient detail to advise the bondholder in the bond of his exact rights and lack of rights in respect thereto. Some courts have held that it is not sufficient to have these provisions set out in the mortgage, with a scanty reference to the mortgage in the bond. Other courts have held that where the mortgage referred to the bond the mortgage could be held to govern. But, in fairness to the bondholder, such a recital should be so made as to be a part of the contract.

A great bulk of the issues of bonds issued throughout the country are lithographed or printed bonds, put out cheaply and without much care. In very many localities which do put out bonds continually the people are not familiar with the requirements for listing of bonds upon stock exchanges. Many issues are put out each year, with no thought of listing them upon the stock exchanges, when, years later, it is found that it would be very desirable if the bonds could be listed. It would be, indeed, very advisable if some means could be taken to acquaint the public more generally with the requirements of the various stock exchanges, and especially that all large issues of quasi-public and industrial corporations should be made to comply with the rules of the stock exchanges, so that bonds would be properly certified by an independent trustee and such form adopted as would bring bonds within the rules and regulations of stock exchanges and permit them to be listed.

Municipal bonds are very different in many respects from the bonds of the ordinary corporation. While it is true that all bonds are, to some extent, regulated by statutes, still much more attention has to be given to the issuing of a municipal bond than to many so-called "corporate bonds." Municipalities are not held to a strict accounting of debts and obligations incurred, unless the same are legally incurred, and it has too frequently happened that municipalities have sought (and in cases succeeded) to avoid their just obligations upon purely technical grounds. It is, therefore, most important that every safeguard possible be thrown around the issue of municipal bonds. It should be the object of every municipality, including of course hamlets, school districts, and everything of that character, to obtain the highest price possible for their bond issue as well as to give the bondholder the greatest security. There has grown up, therefore, a class of recitals which it is ordinarily expected to find in a municipal bond, by which the municipality guarantees that all its actions have been regular, and that everything necessary to be done has been done to make the bond a binding obligation upon the municipality; that the total indebtedness of the municipality, including the issue of which the bond is one, does not exceed the constitutional or statutory limits of indebtedness, and that the tax necessary to pay the same does not exceed any constitutional or statutory limitation thereof.

Many bonds are put out by various municipalities that are known as "improvement bonds," and the question is sometimes an interesting and close one as to whether such bonds are payable only out of assessments collected upon property benefited; or, in the event that such assessments turn out invalid, for any reason, or insufficient when they are collected, to pay the bonds, whether the bonds become general obligations of the municipality.

It is hardly possible to do more than to suggest these various questions, in the way of warning the bond buyer that it is necessary to have all matters of this character looked into before the municipal bond is purchased.

In the older states, by reason of very thorough examinations for the last few years, the municipalities, or many of them, are being educated to examine carefully the statutes before their bonds are issued, and to conform to the statutes and have their record in complete shape before their bonds are offered; but, frequently, municipalities seem almost to go wild in their desire to aid some railroad or similar industry that they think will help their particular locality and to issue aid bonds. Such bonds have brought a great deal of litigation, as the result is frequently the same as promoting any enterprise, the aid furnished does not bring the result anticipated, and technical advantage is sought to be taken of any mistake or omission in the issue.

Generally speaking, it may be said that the recitals in municipal bonds should also contain a reference to the laws under which the bonds are issued, the purpose of the issue and a reference to the proceedings authorizing the issue. Then the bond buyer should insist that the bond should contain a broad general recital to the effect that all acts, conditions and things necessary to be done precedent to the issue of the bonds, in order to make them legal, binding and valid obligations of the municipality, have been done in regular and due form, as required by law; and that the faith, credit and revenues and all the property of the municipality are pledged, either directly for the prompt payment of the principal and interest of the bonds at maturity, or in such a way as to obligate the municipality to see that the assessments or taxes are levied and collected to pay the bonds at maturity, and that the total indebtedness, including the issue of the bonds, does not exceed the constitutional or

statutory limit of indebtedness, and that the municipality has the right to collect the necessary tax or assessment to pay the bonds.

It must be borne in mind all the time, however, that there are some things that a municipality cannot contract to do, and that there are some things it may, by recital in bonds, estop itself from afterwards disputing. No municipal bond should be put out or purchased until some one shall have thoroughly examined into the situation and passed upon it. This obligation should be upon the municipality. It would, to quite an extent, raise the value of all government, state and municipal bonds if they could be issued in such a manner that there would be no disputing of the obligation when once put out. To have such credit as that is what every government and every state should desire for all of its municipalities.